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IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 74—1630

TITAN GROUP, INC.,

Petitioner,

against

HAROLD FAGGEN,

Respondent.

REPLY PETITION TO CORRECT STATEMENTS BY RESPONDENTS AND OTHER MATTERS

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We find the unusual necessity of filing a Reply Petition for the following reasons. On page 3 of Respondent's Brief In Opposition, a serious and incorrect assertion is made that Petitioner "distorts the record" as to the "$386,922 (40%) shrinkage of the $1 million gross actuarial business of the Faggen Companies between 1966 and 1973." As will be shown, it is Respondent who distorts the record on this undisputed factual matter:

1. *Loss of Clients.* The Faggen Companies were acquired from Respondent Harold Faggen on December 2, 1968. Any new business they acquired in 1969, which offset *undisclosed* losses of clients in 1968, did not correct

omissions to disclose before Titan made the acquisition. Titan bought a presumably growing business, at ten times future earnings, not one that was, at best, standing still, and scurrying, after the acquisition was closed, to make up for undisclosed lost clients with new clients. And even with later new clients, the net trend was materially downward from 1968 through 1973, with the adverse trend undisclosed as of December 2, 1968.

The facts on this point are plain in the record. Faggen said in his own handwriting in his 1968 selling memo to Titan:

"Analysis of Clients

	Pension Funds	*Welfare Funds*	*Other*	*Total*
New in 1968	2		2	4
New in 1967	3	1	3	7
New in 1966	5	1	1	7
New in 1965		1	1	2
New in 1960-1964	19	14	2	35
Began prior to 1960	49	36	3	88
Total	78	53	12	143"

(Trial App. 1366, 1372)

Compare this "bullish" presentation of a growing business, adding several new clients yearly through 1968 for a total of 143, with the schedule of lost clients undisclosed, in the record:

Schedule of Lost Clients

TITAN ACTUARIAL SERVICES, INC.
1964-1973

Fiscal Year Ended June 30, 1966		
Local 26 Pension Fund		$ 2,000
Fiscal Year Ended June 30, 1967		
I.U.O.E. Welfare Fund Local 137A, 137B	$ 2,400	
Supplemental Unemployment Benefit Fund Local 137	2,400	
		$ 4,800
Fiscal Year Ended June 30, 1968		
Bartenders Union Loc. 29 Pension	2,500	
Bartenders Union Loc. 29 Welfare	2,000	
NYC District Council of Carpenters Union	50,000	
NYC District Council of Carpenters Welfare	28,000	
Local 164 Insurance Fund	3,600	
Local 164 Pension Fund	2,100	
Metro I.L.A. Pension Fund	4,500	
Upstate Printers Pension	2,000	
Local 806 Teamsters Pension	2,000	
		$96,700
. . . [1969-1973]		.....

(Trial App. 1396-1398)

The undisclosed 10% loss of clientele before the acquisition closed is there in the 1966-1968 entries, bound to adversely affect profits thereafter by some 20% (since

overhead remained the same). There was no disclosure of the loss of the single biggest client group—NYC District Council of Carpenters ($78,000 annually), nor of the beginning of loss of the whole Bartenders' Union Group in 1968, culminating in 1969 (see balance of this exhibit, 1969-73, Trial App. 1396-1398). The factual assertions on page 6 of our Petition, detailing omissions to disclose material decline in clients are indisputable.

In a desperate attempt to avoid these facts, Respondent quotes the Record on a single question by the Court as to a large new client obtained in 1969, *after* the acquisition (and therefore irrelevant to non-disclosures before acquisition). The question dealt with the continuing decline in actuarial consulting business after acquisition, while a doomed attempt at going into the computer business became an increasing source of volume to the Faggen Companies (all handled at a substantial loss). We quote the transcript page cited by Respondent:

> "A. So I would say what was happening was the data processing was taking over a larger and larger portion of the total volume of business. Percentage wise, it got to the point where it was probably thirty, forty percent of the total volume of the company.
>
> Q. [the Court] What was happening to the actuarial business during this period in terms of volume?
>
> • • •
>
> A. Well, in '69 we lost over $100 thousand just in clients, just to Levin Townsend, so there was some shrinkage there. Let me put it this way. A unique thing happened, we lost maybe forty clients whose total billing may have amounted to $300 thousand or maybe under $300 thousand, maybe 250, and they were replaced instantly by one client whose volume exceeded that. . . . the actuarial volume, it probably stayed about the same." (Trial App. 811-812)

Confirming that this testimony related only to what happened *after* the acquisition, events that in fact masked the undisclosed decline in clientele before the 1968 closing, we quote the page cited by Respondent:

> "The Court: All right. Now am I also right in understanding that as time went along *up through 1969 up through 1972,* let us say, that the actuarial business gradually came to represent a lesser percentile of the total gross volume than it had when you first arrived say in '68?
>
> The Witness: Right.
>
> The Court: . . . you picked up one new client which practically absorbed or virtually came close to absorbing the loss of billings or volume which went out with the forty?
>
> The Witness: Yes." (Trial App. 819-820)

More significantly, the forty lost clients referred to are those lost to Levin Townsend early in 1969 (a list of 34, actually, Trial App. 1397). Before the acquisition, there was an undisclosed loss of 12 other clients, with aggregate gross billings of $103,500. These in themselves were the key material omission—10% of volume, and 20% decline in profits. The Levin Townsend loss of clients was simply another $109,682 in annual billings lost in 1969 after the acquisition closed.

It is these hard facts which make up the substance of an objective test for materiality of a non-disclosure. What happened later to cover up an undisclosed decline in gross business is irrelevant to whether a reasonable investor might have wanted to know the conceded decline as of December, 1968. The District Court ignored an objective standard for evaluating an omission when it occurred, and used subsequent events as a basis to call the omission inconsequential. Its erroneous reasoning demonstrates the need for review under the test set forth in *Affiliated Ute Citizens* v. *U. S.,* 406 U.S. 89 (1972).

2. *Receipts and Disbursements by each Litigant.* Respondent argues on page 2 of its brief: "Before having made any payment on account of principal and after the Petitioner had withdrawn more than $2,000,000 in cash . . . from the Faggen Companies, Petitioner defaulted in its interest payment and . . . commenced this action to rescind the transaction." The Respondent erroneously suggests that there is something wrong in a parent of a wholly-owned subsidiary taking excess net worth in the subsidiary, held in cash and marketable securities, and liquidating them for use in other divisions of the parent corporation's business. The Respondent also fails to state that Titan Group, Inc. caused to be paid to Respondent, Harold Faggen, $660,000 in interest plus substantial salary payments and expense allowances to Mr. Faggen and his wife, aggregating a total of over $1 million between the acquisition date of the Faggen companies and the filing of this action claiming fraud. Moreover, Titan at all times claimed that the value of the Faggen companies was approximately $1.6 million to $2 million in its recent action, subject to setoffs and adjustments to each party to the contract. Respondent attempts to obtain some perjorative effect from the normal handling of the cash and other assets of a wholly-owned subsidiary by a parent corporation after purchase, during the fiscal years before investigation led to the conclusion that the parent corporation had been defrauded, and must take court action to establish each party's respective claim.

3. *The Objective Test of Affiliated Ute Is Being Uniformly Applied by the Circuits, Except for the Anomaly in the Instant Case.* Respondent attempts to argue that the language of Rule 10b-5(2), taken from Section 17(a) of the Securities Act of 1933 and incorporated in a parallel anti-fraud rule of the Securities Exchange Act of 1934, creates a statutory test for deception which is other than the "reasonable man" test of general tort law and *Affiliated Ute Citizens* v. *U. S., supra.* Respondent urges that the language omitted "to state a material fact, necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" means that a circumstantial test must be applied by a trier of fact to determine *materiality* in an omissions case. Nothing could be further from the Congressional intent or the clear stream of authority under Rule 10b-5. As Bromberg, SECURITIES LAW, Sec. 2.6(2), points out under Rule 10b-5(2): "Clause 2, by its own terms, operates only if some statement is made and this outlaws half truths and other forms of partial silence or failure to disclose." In other words, the statutory test for the deceptiveness of an omission is whether, "in the light of the circumstances" under which other statements were made, material facts should have been disclosed, because they were "necessary in order to make the statements made" not misleading. In substance, an omission to state a material fact necessary to make other statements not misleading, always requires other statements to have been made. This principle of interpretation in *Bromberg* is cited with approval in *Affiliated Ute Citizens* v. *U. S.*, 406 U.S. at 154. In the instant case, the other statements that were made consisted of a list of new clients noted above, and a statement of adjusted net income quoted in our Petition. It was the omissions from these statements which were necessary in order to make these statements, in the light of the circumstances under which they were made, i.e. factual inducements to a transaction in securities, not misleading. Respondent's argument, based on the statutory language, is wide of the mark on the issue in the instant case.

The issue here is the *materiality* of the particular omissions under analysis. And on the materiality question the *Affiliated Ute* test is the objective one, whether a reasonable investor might have considered the omissions important. Respondent's brief is an attempt to take the language "in the light of the circumstances under which they were made" out of its statutory context, applicable to the *statements made,* and transfer that concept of a cir-

cumstantial test into an analysis of *materiality* of omissions. With all respect, it is mixing apples with oranges.

The authorities cited in a lengthy string of citations in support of Respondent's erroneous theory do not withstand analysis. Taking two of the most recent authorities in the Sixth and Ninth Circuits, we note the following:

In *Arber* v. *Essex Wire Corporation,* 490 F. 2d 414 (6th Cir., 1974), the plaintiff was unable to meet his burden of proof under Rule 10b-5 and lost the case. But the analytical test used by the Court was based on *Affiliated Ute Citizens, supra,* and was exactly the objective test which we urge should have been used by the Second Circuit and by the District Court in the instant case. At 490 F. 2d 418, the Sixth Circuit articulates the "reasonable man" test in an omissions case, and states that it is taking the omissions "to assess the significance, from a reasonable person's viewpoint in the context of the 1961 sale, of any nondisclosures." In stating its conclusion (490 F. 2d 419-420), the Court said:

> ". . . In this context, we do not think that detailed knowledge of the precise mechanism for establishing the 'going price' would have affected the choice of action of a reasonable person in the position of the Arbers."

The Sixth Circuit further stated (490 F. 2d, 421, ftn. 7) in referring to the *Ute* test:

> "This, of course, makes clear that the Record in a 10b-5 action for nondisclosure need not contain an affirmative demonstration of plaintiffs' reliance."

Another recent citation by respondent, *Robinson* v. *Cupples Container Co.,* 513 F. 2d 1274 (9th Cir. 1975), wherein the plaintiff also did not make his case, further demonstrates the uniform application in the Circuits of the *Ute* test. The Ninth Circuit (513 F. 2d, at 1277) applied a

principle it had stated in *Marx* v. *Computer Sciences Corporation,* 507 F. 2d 485, 489 (9th Cir. 1974):

> "The applicable test of materiality is essentially objective . . . in determining his choice of action in the transaction in question.' . . ."

Indicating the analytical test used by the Ninth Circuit, the Court stated in the dispositive portion of its opinion, "The alleged promise of employment cannot be regarded as a matter to which a reasonable investor would attach importance where it was made at an exploratory meeting . . ." (513 F.2d at 1278). In the *Robinson* case the plaintiff was claiming that it was represented to him that defendant intended to place him in charge of all cup manufacturing operations after the merger, and defendant had no such intention; the Court thus held a reasonable man would not have attached importance to such vague statement of intent.

For another recent statement of the applicable "might have considered important" test, see the Seventh Circuit in *Northway, Inc.* v. *TSC Industries, Inc.,* CCH Sec. L. Rep. ¶ 95,007 at p. 97,487 (—— F. 2d ——, March 5, 1975).

In the instant case, the same reasonable man test should have been applied to the written representations of (a) new clients and (b) substantial earning power, where there were omissions of substance relating to each of these written statements. Obviously, a court must inquire into the nature of the securities transaction to decide what might be important to the reasonable investor in that type of transaction. In an acquisition transaction, it is hard to conceive of anything being more material than (a) the gross volume of business of the acquiree, and whether or not such volume is declining, and (b) the earning power of the acquiree, together with the conceptual framework used to demonstrate such power, i.e., the basis for the "adjustments." "The value of an acquired firm is determined, in part, by the stream of earnings which it is expected to

contribute to the acquiring firm." *Champion Home Builders Co.* v. *Jeffress,* CCH Sec. L. Rep. ¶ 94,973 at p. 97,364 (1974, E.D. Mich.).

4. *The Contract Documents Are of Little Signifiance Herein.* At bottom, respondent's position is one which was rejected even by the District Court. It is an argument that, if the formal contracts did not contain references to the items of fact as to which there were claimed material omissions, a plaintiff cannot base a Rule 10b-5 case on such omissions. The peroration of Respondent's brief (p. 10) stresses this position, that if the financial statements on a cash basis of a privately held business as incorporated in their tax returns were annexed to the contract, and proved to be accurate as prepared, then plaintiff cannot look beyond the contract documents to show material omissions and other factual statements presented to induce the transaction. Such principle was rejected many decades ago in decisions like *Arnold* v. *National Aniline & Chemical Co.,* 20 F. 2d 364, 369 (2d Cir. 1927)—"No form of contract can stand if induced by fraud." No contract can grant immunity from fraud in its inducement, *Sabo* v. *Delman,* 3 N.Y. 2d 155 (1957). Fraud, including fraud based upon material omissions to disclose, vitiates any contract despite provisions that all understandings are merged therein, that an investigation has been made, that there was no reliance on any representation by an exhibit not in the agreement, or that complaint must be made within a specified time period. *Rizzi* v. *Sussman,* 195 N. Y. S. 2d 672 (A.D. 2d, 1959); *Massler* v. *Smit,* 111 N.Y.S. 2d 264 (A.D. 2d, 1952). Section 29(b) of the Securities Exchange Act of 1934 expands upon this common law principle—"The statute would be of little value unless a party to the contract could apply to the Courts to relieve himself of obligations under it or to escape its consequences." *Kardon* v. *National Gypsum Co.,* 69 F. Supp. 512, 514 (E.D., Pa. 1946). Bromberg, *supra,* pp. 31-32, and Loss on SECURITIES REGULATIONS, p. 1757, ground the whole field of civil liability under Rule

10b-5 on this principle, that the presence or absence of an exhibit or of a representation, or any other acquisition contract "boilerplate" cannot foreclose a fraud inquiry which searches the record. See *Rogen* v. *Ilikon Corporation,* 361 F. 2d 260 (1st Cir. 1966), and *Bankers Life & Casualty Co.* v. *Bellanca Corp.,* 288 F. 2d 784 (7th Cir. 1961). Respondent's argument was even rejected by the District Court, which said: "The case law supports [you]" for fraud in inducing the contract opens the door to the essential business sales talk used to induce the transaction (Trial App. 1097). Thus, Respondent Faggen could not escape the impact of his detailed list of new clients, omitting material adverse facts, or of his pro forma earnings presentation, omitting questionable adjustments and assumptions, which were the sales tool used to effect a transaction, merely because cash basis tax returns instead of complete financial statements were made part of the contracts. Even the contractual boilerplate, although irrelevant, picks up the selling material which was the key to this case. Section 3.23 of the relevant contract says:

> "*Material Misstatements or Omissions.* No . . . document, statement, certificate or schedule furnished to Titan . . . in connection with the transactions contemplated hereby, contains . . . any untrue statement of a material fact necessary to make the statements or facts contained therein not misleading." (Trial App. 1638-1639)

The list of new clients and a pro forma summary of adjusted income for each corporation for four years are certainly "documents," "statements" or "schedules" furnished to Titan "in connection with" its acquisition transaction. But this was not a suit on a contract, but rather, under the federal securities laws, for fraud in its inducement. The contract provisions, and the accuracy of the financials or other exhibits to the contract, cannot foreclose intensive analysis of the selling memorandum used to induce the

contract. And that analysis, we respectfully submit, must be pursuant to the objective test for materiality of *Affiliated Ute,* in order to measure the significance of the omissions from this selling memorandum.

CONCLUSION

We respectfully pray that the petition for certiorari be granted to review this important principle of federal securities law in the instant case.

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